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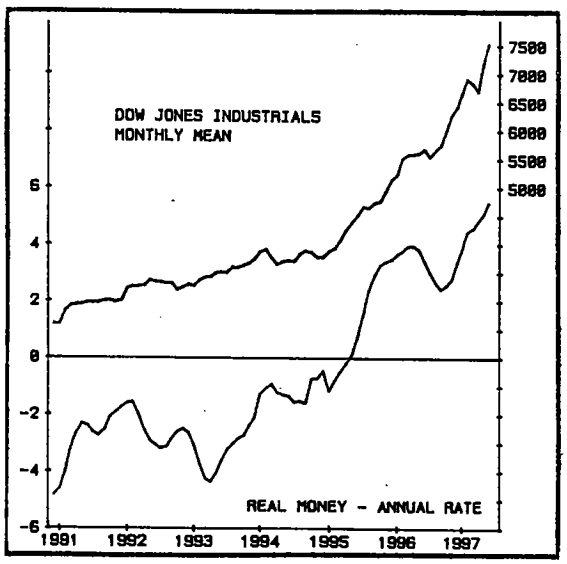
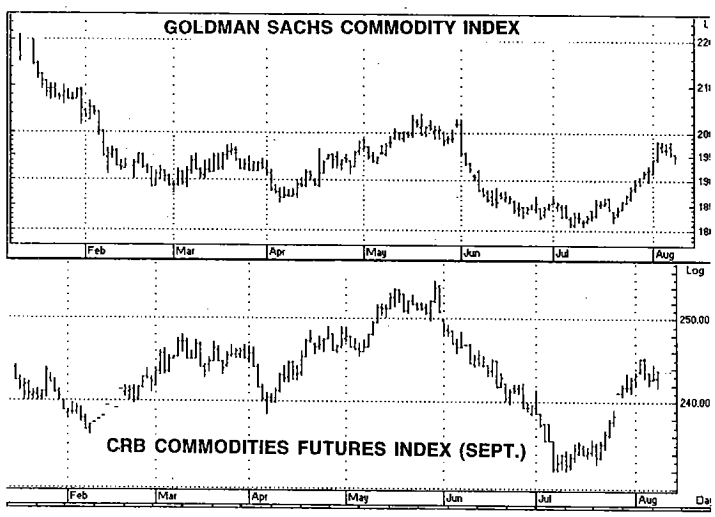
Aug. 13, 1997 **LETTER 1232**

INFLATION?: There's been a widespread consensus that there's "NO INFLATION" in the US economy. Is that consensus about to be proven wrong? I'm thinking, "Maybe." (For more, see the page 6 Gold section.)

(1) The broad M-3 money supply has been rising at a 7.4% rate. This chart shows that the annualized rate of "real money" (i.e., money adjusted for inflation) has been surging, telling us that despite Greenspan's warnings, the Fed has definitely been fueling the bull market (chart courtesy of *Junction Recognition,* Box 1209, Pompano Beach, FL 33061). Question: If money is being created, won't it be used?

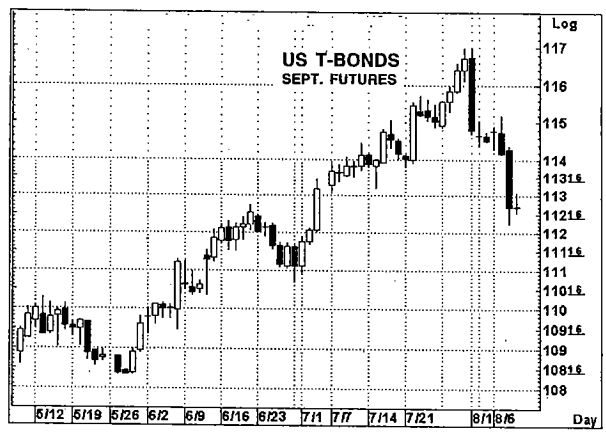


(2) The Commodity Indices have been rising ever since their July 7 lows. The Goldman Index is more heavily weighted for energy while the CRB is more heavily weighted for agriculturals. But they've BOTH been heading sharply higher.



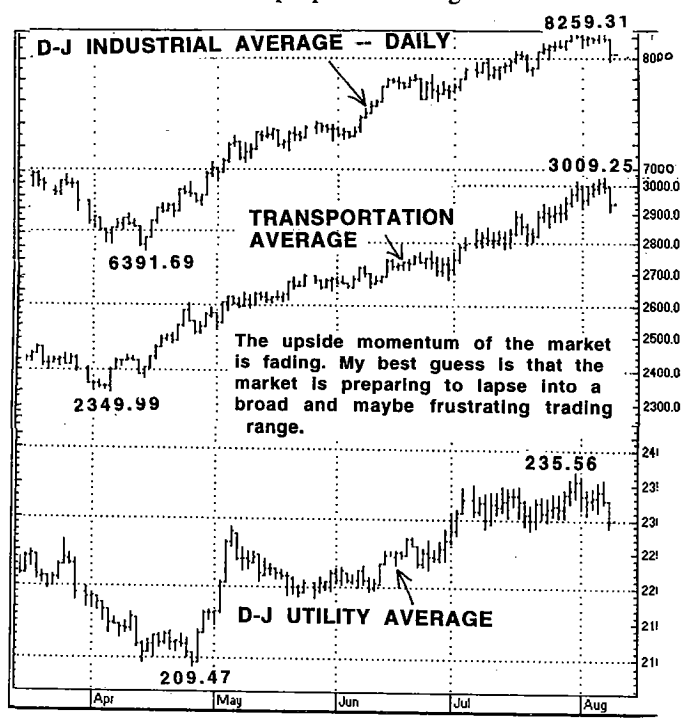
(3) The bonds were hit **very hard** last week, indicating that they've topped out for the duration or at very best they've moved

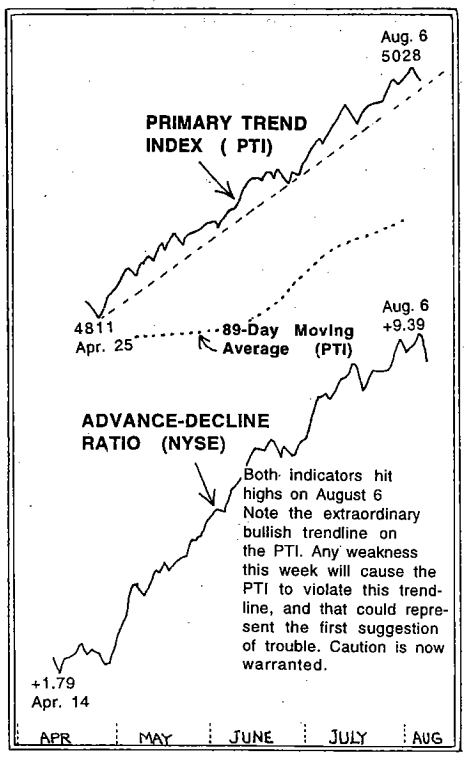
Aug. 1 DJIA 8194.04; PTI 5012; A-D Ratio +8.98
Aug. 8 DJIA 8031.22; PTI 5016; A-D Ratio +8.72
Dow Yield: 1.61%; Dow Price/Earnings: 21.5
Dow 144-day MA: 7298; Dow 34-day MA: 7972
Dow Times Book Value: 5.67; PTI 89-day MA: 4905
Percentage of Undervalued Blue-chips: 4%
Gold 144-day MA: 351



into a trading range. As far as the Street's hoped-for 6% rate on the long bond, it's safe to say that you can forget it -- unless there's a recession in our future (and I don't totally rule that out).

(4) Over the last few years (with the help of the Fed and the rising stock market) a vast amount of liquidity has been created in the economy. Commercial and residential real estate prices are now moving up. The inventory of new homes is at a four-year low. Corporations are finding it more difficult to find even semi-competent workers. Auction prices for art and jewelry and collectibles have moved up substantially. Restaurants are packed. Resorts are mobbed. And people are smiling.

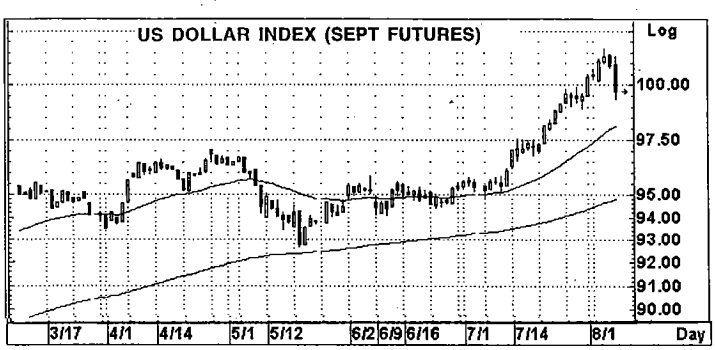




INFLATION? Here's what I think has happened. With the rise of global competition, pricing power (the ability to raise prices) on every-day items, the items that the government follows in its CPI, has been stable. Manufacturers and retailers haven't been able to raise prices -- competition, both domestic and foreign, has just been too severe (furthermore, retailers have had to deal with the rise of "category killer" stores and discount stores plus very competitive consumer buying via the Internet).

However, in many other areas, costs have risen. Inflation is occurring mainly in the items which the wealthy deal with. I'm talking about taxes, common stocks, luxury homes, resort rentals, commercial real estate, meals in better restaurants, art, diamonds and jewelry, designer clothing, gold watches, tickets to Broadway shows, movie tickets, high-end autos, auction items, etc.

Conclusion: There's plenty of inflation -- it just doesn't show up in the government statistics. One phenomenon holding back inflation has been the **powerful dollar.** A powerful dollar means that goods imported to the US are cheap, and cheap imports compete with US goods. It looks as though the whole world wants to move into dollars. And why not -- the dollar is the currency of the nation with the strongest economy and the highest interest rates. Result -- the dollar has been rising against everything -- the yen, the European currencies, the Asian currencies and gold. THAT IS, UNTIL LATE LAST WEEK!



PRICE ACTION: Last week ended in something akin to chaos. The bonds caved in, the stock market swooned, the dollar got socked (with the yen surging), and gold pushed higher as did the gold stocks.

The most intelligent words I heard on the situation came from a veteran commodity trader: "There's no reason for the bonds to be falling apart in this way; everything points to fundamental trouble in the system." By the system, the trader was referring to the whole global financial structure, which in turn means foreign selling of US bonds in order to raise much-needed cash.

The stock market can take a lot of problems, but one thing it can't take is higher interest rates. And when bonds sink, interest rates rise -- thus, last week's trouble.

One swallow doesn't make a spring, and one rotten week doesn't make a bear market. We'll have to see a lot more before we can say that the greatest bull market in history has rolled over and died.

One danger, and one that I've often talked about, is the fact that stocks have been so broadly distributed to the PUBLIC. The public has been buying stocks and funds at an accelerating rate, and as of now they are LOADED with equity. Nobody knows how millions of Americans will act if we see anything like a severe correction, much less a bear market.

The market has avoided anything like a severe correction for seven years. The public has been bombarded with propaganda to the effect that stocks are the royal road to prosperity and a luxurious retirement. Thousands of mutual funds have been established and dozens of index funds have been created. No question about it, the public owns a mountain of stocks. How those stocks behave and how the public behaves will, in my opinion, be the key to the US economy over the next few years.

THE MARKET: Here's an interesting story: Dow dividends today are 129.65. One year ago they were 124.74. So Dow dividends have risen **3.9%** over the last 12 months. Dow earnings today are 372.04; one year ago they were 316.96, so over the last 12 months earnings have risen **17.3%**. Today the Dow is around 8031. One year ago the Dow was at 5681. So over the last 12 months the Dow has risen roughly 35%.

Question: With Dow earnings up 17.3% and dividends up 3.9%, how could the Dow have advanced 35%? My answer -- what we've been witnessing is not a "new era." And it's not a Wall Street miscalculation. No, what we've been seeing is a **major revaluation.** The revaluation has been based on **surging corporate profits and declining interest rates.** The rising corporate profits are a function of improving workers' productivity, down-sizing of corporations, new efficiencies based on computerization, and the rise of global markets.

At this point I think the revaluation is just about over. In other words, I believe the stock market is just about where it should be **if you're using projected earnings** and **current interest rates.** Since the market has already priced in rising profits of 15% for 1998, the big variable, as I see it, will be **interest rates.**

Question: What was the revaluation all about or how did it work? **Answer:** The method which has gained very wide acceptance is projected Dow or S&P earnings adjusted for interest rates on the long-bond -- and bond rates in turn reflect anticipated inflation rates. *Investor's Business Daily* provided this chart showing possible Dow prices based on projected Dow earnings and inflation rates.

Fairly Valued?

S&P EPS	Inflation 2.75%	2.5%	2.25%	2%
$38	6,263*	6,888	7,871	9,183
40	6,560	7,250	8,286	9,667
42	6,888	7,613	8,700	10,150
44	7,300	8,066	9,218	10,754
46	7,544	8,338	9,529	11,117
48	7,871	8,700	9,943	11,600
50	8,199	9,063	10,357	12,083

**estimate of "fair value" for the Dow Jones Industrial Average*

A commonly accepted estimate for next year's S&P earnings is $47. Referring to the table, if next year's inflation rate is 2.5% you'd be looking for a Dow above

8700. If you expect a 2.75% inflation rate, then you'd be looking for the Dow around 7900. Of course, earnings can change rapidly, inflation can heat up or disappear, and interest rates will change accordingly.

But the reason this method has become so popular is that it **explains what has happened.** It explains the revaluation phenomenon and the huge rise in the stock market better than anything else. So it's the old story -- the logical and accepted explanations are there -- AFTER the fact.

CONCLUSION: The **big variable,** now that the stock market has priced in roughly a 15% increase in next year's Dow earnings, is **interest rates.** To take it a step further, the story in interest rates will be told in the inflation rate and the **best barometer of inflation is GOLD.** And gold is starting to look a lot stronger (see page 6 Gold section). If there's one phenomenon which will halt this market's rise it's a bull trend in gold.

Yields, Earnings: It's always tricky and risky to estimate earnings a year or even six months ahead. However, **dividends tend to be steady,** since corporations think carefully before raising or lowering dividends. But earnings can be erratic, and they can change rapidly over any six month period. For this reason, old-timers have always tended to give prominence to YIELDS, rather than earnings.

Nevertheless, over recent years analysts have paid less and less attention to Dow yields. The reason is obvious -- when, in 1993, the yield on the Dow sank below the 3% level (historically, this was a danger signal), the Dow simply ignored it and continued to advance. Dow yields dropped further and further into uncharted territory, until last week we saw the Dow yield sink to an unprecedented **1.57%.** Ten years ago a Dow yield below 2.5% would have been thought impossible.

Notes: Based on next year's projected earnings of 490 for the Dow and current dividends of 129.37, the dividend payout for the Dow is a very low **26%** (the normal historic payout is nearer to 50%). This explains why analysts have totally ignored the yield on the Dow.

If the Dow were to sell at the old danger level of a 3% yield, it would sell at (gulp) 4502. If the Dow were to sell at the historical bear market bottom yield level of 6%, it would sell at 2251.

How about all these **cycles** that haven't worked? My old friend, Joe Granville (who is extremely bullish) has a lot to say about this. Writes Joe in his July 24 Letter, "Yes, the current cycle is surely a unique phase of human experience. Yes, it will end, but the length of the cycle is a mystery and fits no previous cycle. The bears are starving and pray that each blowoff followed by a downturn is the start of the long-awaited bear market. Periodically, the market gives the appearance of a blowoff followed by a sharp better than 100-point pullback. While the bears hang on to each of those sharp down-days, several days later the Dow manages to see new record highs again . . . So what we have here is a market that constantly keeps reinventing itself with money transfusions. When it looks like the market might be getting into trouble it keeps getting bailed out. Money cuts through everything. As long as this huge inflow of cash into mutual funds continues, the tidal wave can wash over all temporary negative market patterns."

Joe believes that the flood of money has simply erased the "normal" cycles, and it's clear that, so far, this has been the case. The Presidential four-year cycle, the Kondratieff long-wave cycle, the decennial cycle, where are they? As I've said many times before regarding cycles, they're interesting -- but they're not reliable. My attitude towards cycles has been expressed before, and it is this, "Cycles are fascinating, but where are they when you need 'em?"

Note: Back in the 1950s, my old buddy, Wayne Marcus, bought a NYSE seat for $70,000. Good buy, Wayne. Last week a seat on the NYSE sold for a record $1.425 million, up $125,000 from the previous sale. Seat prices tend to rise with NYSE volume. (P.S. Wayne called last week; he still owns the seat.)

INVESTMENT POSITION: The bull is in the box, and it's going to take a lot more than I've seen so far to knock El Toro out of the box.

The hardest part of any market analysis (including this one) is separating what you think the market "should be doing" vs. what the market is ACTUALLY doing. Everybody has a variation or a different idea regarding what they think the market should be doing -- and that can be costly. But it's critical to get with **reality,** namely, what the market **is actually doing.** For the key to what the market is actually doing, I know of no better device than my PTI.

In recent Letters I suggested that a rational investment at this time was 2 to 5 year government bonds. I'm now advocating going out 10 years in Treasury bonds. If you're ready to buy bonds, look for issues with the least premium over par -- in other words, buy bonds priced around 100 or less along with the best yield you can find in this category (your broker should be able to provide this information after a search of five minutes or less).

Question: What if my broker can't do this and is not familiar with bonds? Answer: Then get a broker who IS familiar with bonds. Personally, I wouldn't use a broker who is not very familiar with the bond market. It's like hiring a driving instructor who doesn't know how to use a stick shift.

Note: For speculators and gold-philes -- read the Gold section carefully.

NOTES & QUOTES: One of the great mysteries of this whole situation is that the public, which is heavily in mutual funds, has made money in this bull market. Of course, historically, the public always "gets on the right side of a **persistent trend."** It's at the **extremes** where the public tends to be wrong. In other words, the public is most wrong at the bottom of a bear market, at which time they're selling heavily. By the same token the public tends to be most wrong at or near the top of a bull market, at which time they're buying heavily.

In his latest report Joe Granville states that "the public has been pretty damn smart" in this bull market. Joe continues, "My public smart-money concept is disturbing because it goes against virtually everything we know about the stock market. Everything is now reversed."

This is Joe's new theory, but I'm skeptical. I'm skeptical because the whole story has not been told yet. If the public comes out of this cycle with profits, then yes, I'll agree with Joe that this time "everything is reversed" and we have a new, sophisticated, market-wise public.

What we do know is that 43% of Americans now own stocks. Will they hold these stocks through the next bear market? Will there ever be another bear market? Is the public right this time and will the value investors who are now selling be wrong? Only time will tell, but my thoughts are as follows: Nothing has really changed except the duration and extent of this bull market and the extremes in valuation. In the end, stocks will return to Wall Street (during the next bear market) and the public will end up cursing, as usual, "those villains and con-artists of lower Manhattan."

Here's another point, however. This bull market has been the hardest on the old-timers who are guided by historical norms of values and duration and extent. The neophytes who just bought 'em because they were going up or the people who bought mutual funds because "this is the way to provide for my future," they've obviously done the best SO FAR. But again I repeat that the story's still unfolding. It's how you come out at the **end of the cycle**

(bull to bear) that constitutes the bottom line. And we haven't reached the bottom line yet.

* *

Housing prices are moving up across the nation, and in many areas they've been surging higher. Commercial real estate has firmed considerably, and business and residential space for rent are becoming scarce in many cities. As mentioned before in these Letters, high-end jewelry and gems have already risen substantially in price, and my local jewelry sources tell me that large diamonds have rocketed "out of sight." In NYC the average price for a two-bedroom apartment has shot up by 29% over the last 12 months to $781,610.

* *

Computers, chips, clothing, toys -- no inflation there. But buy an airline ticket, pay your tax bill, rent an apartment, buy a home, see a movie, call a plumber, and you'll experience the "silent inflation." Or you might ask yourself this -- "Is it costing me less to live here in 1997 than it did a year ago?"

* *

It's Starting: I'm talking about the publicity for the new index futures and options on the **Dow.** They'll start trading on the Chicago Board of Trade in the fall. I got a glossy promotional flyer in the mail today, and it's headlined, **"19 Seminars, 17 cities, 30 Blue Chips, One Index."** The Dow futures will be worth 10 times the price of the Dow; for instance, if the Dow is at 8,000 the Dow Futures will translate into $80,000 worth of Dow stocks (which makes the Dow future much smaller than the S&P future, which sells at 500 times the price of the S&P and are worth roughly $475,000). **Russell prediction** -- volume in the Dow futures and options will be HUGE. And the **public** will trade them big time. The public has never understood the S&P futures and options, but they will understand the Dow's derivatives.

* *

Gates Again: Microsoft is sitting with **$9 billion** in cash -- and that hoard is earning the company roughly $18 million every single day. As this is written, MSFT has bought 45 other companies. And it's clear that Gates believes that the future for MSFT, as far as growth is concerned, is not in software but in entertainment and communications. One area MSFT has moved into is "Sidewalk," which is the Internet program which will cover the world (in due time), city by city. Information in each city will include restaurant reviews, movie reviews, points of interest, hotels, special events, etc. My guess is that Microsoft will be competing with newspapers and probably films. When you've got $9 billion and unlimited talent and ambition -- there are a lot of areas open to you. And if you can't do it yourself, you can buy the company that can do it. It's no wonder everyone is terrified or traumatized by MSFT. So what does Microsoft really want? Said senior analyst, Jim Penhune, of the Yankee Group, "Microsoft's strategic objective is to expand its presence beyond the desktop. They want the Windows brand, not just on PCs, but on TVs, phones, hand-held devices and other non-PC devices in the home." This from Philip Monego, Net Channel CEO: "Microsoft's recent purchase of WebTV brings it one step closer to fulfilling its strategy of dominating all aspects of the entertainment, electronic commerce and communications industry. Microsoft is becoming a standard, not a software company, positioned to collect a toll at virtually every link in the communications delivery system."

* *

Oops, make that 46 companies that MSFT has bought. This clip is from the August 6 *NY Times.* On the same day MSFT announced it was investing $150 million in Apple. Why? MSFT has an interest in keeping Apple alive (but not too alive) to ward off any anti-trust suits. Also, with this deal, MSFT and Apple could become important allies against Netscape and Sun Microsystems in the critical area of developing software for the Internet.

* *

France and Germany are both suffering from record unemployment, 11.5% in Germany and 12.5% in France. The record unemployment will prevent both countries from raising interest rates (which would be politically almost impossible).

* *

Wall Street has almost always had its **gurus,** probably starting with Charles Dow at the turn of the century. In the years since I started writing these Letters back in 1958 I've seen gurus come, and I've seen them go, dozens of them. This isn't to disparage the gurus, it's just that nobody gets it right consistently when it comes to the stock market. Older subscribers know the Russell adage, "There are no geniuses on Wall Street, only geniuses for a while."

Smart Money magazine now grades what they term "Wall Street's top strategists." Monthly, these poor devils get marked by the magazine. Leading the parade in the latest reading is Goldman Sachs' Abbey Cohen with a *Smart Money* rating of 0.734. Next came Morgan Stanley's Byron Wein with a score of 0.588. Ed Yardeni scored 0.582 and Elaine Garzarelli showed a 0.534. And so on. The danger, in this procedure, of course, is that this month's most correct analyst is liable to be the most wrong by year-end. But there is no question about it -- Abbey Cohen is now the reigning queen of analysts. Most recently, she was still mildly bullish, looking for the Dow to push to 8250 in 1998. **Note:** Goldman Sachs has not made Abbey a partner yet. It seems that partnership at Goldman has something to do with bottom line profits.

* *

Michael Bloomberg (the CEO of the fabulously successful Bloomberg empire) is quite a character. Asked why he won't attend going-away parties for his employees, Bloomberg says, "Why should I? I don't wish them ill, but I can't exactly wish them well either. I wouldn't mean it. We're dependent on one another -- and when someone departs, those of us who stay are hurt . . . we have a loyalty to us. Leave, and you're them." As to whether success wrecked his marriage, Bloomberg says, "Over the years we gradually drifted apart . . . Business is a very important part of my life; she almost never came to visit my office. Nothing wrong per se. We just developed separate lives." Bloomberg, a rich man and an honest man.

*

Football is here, and you can now place your bets on the winner of the next Super Bowl. The coming Super Bowl will be played in God's country, better known as San Diego. Here are expert Danny Sheridan's odds, which are followed everywhere.

* *

Hollywood is holding its collective breath. The reason is Titanic, the movie which is pushing $300 million in costs. This will make it the most expensive flick in history. Two studios, Twentieth Century Fox and Paramount, have financed this giant movie. Writes *Premier* magazine, "Titanic is the kind of epic picture with the power to remake the map of Hollywood, making or breaking careers and affecting entire studio management teams." The film was originally scheduled for July 2 but its perfectionist director couldn't finish the movie on time, so Titanic is now scheduled for a fall release.

Microsoft The Microsoft Corporation said yesterday that it had acquired an Internet start-up company, Vxtreme Inc., to let companies send sound and video over the Internet. Terms were not disclosed. Vxtreme, based in Sunnyvale, Calif., makes software that allows streaming, or the continuous delivery of audio and video to personal computer users. The move follows Microsoft's agreement to license similar technology from Progressive Networks Inc. and to take a 10 percent nonvoting stake in that company. The acquisitions help Microsoft put its stamp on the nascent market for on-line broadcasting. Microsoft shares rose $1.75, to $143.3125. (Bloomberg News)

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NFL

Odds against winning 1998 Super Bowl

Green Bay Packers	3:1
Dallas Cowboys	5:1
San Francisco 49ers	5:1
Denver Broncos	10:1
New England Patriots	12:1
Carolina Panthers	15:1
Oakland Raiders	15:1
Miami Dolphins	25:1
Jacksonville Jaguars	50:1
Pittsburgh Steelers	50:1
Indianapolis Colts	100:1
Kansas City Chiefs	100:1
Philadelphia Eagles	100:1
Seattle Seahawks	250:1
Buffalo Bills	500:1
Chicago Bears	750:1
Detroit Lions	1,000:1
Houston Oilers	1,000:1
Washington Redskins	2,500:1
Cincinnati Bengals	3,000:1
Minnesota Vikings	5,000:1
San Diego Chargers	10,000:1
New York Giants	20,000:1
Tampa Bay Buccaneers	25,000:1
Arizona Cardinals	50,000:1
St. Louis Rams	100,000:1
Baltimore Ravens	500,000:1
Atlanta Falcons	750,000:1
New Orleans Saints	900,000:1
New York Jets	1,000,000:1

* *

What's happening in the center of the civilized world? Here's what's happening, New York is booming. And most of the boom has come courtesy of Wall Street, which last year generated a staggering $11.3 billion in pretax profits. According to the *Washington Post,* "Theaters on Broadway are coming off their most profitable year ever. Hotel occupancy is at an all-time high. Tourism is soaring, subway ridership is up, applications for Barnard College in upper Manhattan have doubled in the past five years . . . Brokers, analysts and investment bankers are making more money than ever. Mid-level earnings range from $150,000 to $300,000 a year. Managers pull down at least $600,000, while top traders take home millions. Just 151,000 people make enough to provide NYC with 14% of its tax revenue, and the taxes these people pay are responsible for NYC's $800,000,000 in surplus this year. Riding the coattails of the Wall Street boom, the fashion industry, luxury retail and real estate are booming." **Russell comment:** 7.3 million New Yorkers are packed into the most densely populated space in the nation. Listen, these poor devils deserve a good time every once in a while. But there's always a spoil-sport: says famed financier Felix Rohatyn (now US Ambassador to France-designate), "There's been a very large creation of wealth by a few. I don't think the Wall Street boom has improved on average the standard of living of most people who live here."

* *

The new Clinton-Republican tax bill is greeted as a triumph of politics, and both parties are waxing poetic. But the London *Economist* is less than enthusiastic; here are their comments: *"It is sad that Republican politicians, who one year ago were lambasting the distorted complexities of America's tax system, are now embracing an agreement that worsens the mess. . . The big winner from the balanced-budget agreement are not ordinary Americans but tax accountants."* Washington loves to spend, spend, spend, but any tax cuts are given grudgingly. For instance, the current inheritance tax allows for $600,000 in deductions. The new tax bill will allow a deduction of $1 million, but stretched out over 10 years or at a rate of 5.2% a year. Instead of this gradual nonsense (who knows what the dollar will be worth in 10 years), why didn't they just eliminate this stupid tax, a tax which accounts for less than 1% of federal revenue. So instead of junking our idiotic, hopelessly complicated tax system and installing a consumption or flat tax, what we get is more shuffling, more piddling nonsensical rearranging. The current tax system won't be jettisoned until we get a Republican Congress and a Republican president, which, from the looks of it, could be a while. (Note: the highly touted tax cuts in the new budget amount to barely three-tenths of 1% of an economy which will hit $7.8 trillion this year.)

Newsweek (Robert Samuelson) in a scathing article writes, "The whole exercise exhibits an enormous contempt for the public's intelligence and integrity. The budget agreement spends more and taxes less. To describe it as a balanced-budget deal violates normal notions of honesty and candor. The bipartisan deceit presumes that so many people will benefit from the deal's various handouts that the public can be gulled into believing almost anything."

* *

Speaking of **taxes**, probably the most insidious of all is the payroll tax. Since 1950 payroll taxes have gone up 3% per decade -- to today's 15.3% for Social Security and Medicare combined. Furthermore, in 1950 only the first $3,000 of income was taxed for SS, while today the first $65,400 is taxed. For a $300,000 salary, the payroll tax amounts to over $16,809 per year. For the same amount, I can buy a good medical plan and save the rest. The payroll tax now costs most Americans more than their income tax.

* *

The **US newspaper industry** is becoming increasingly concentrated. Look at these statistics on the number of newspapers owned: Gannett owns 89 newspapers; Knight Ridder -- 35; Newhouse -- 26; New York Times -- 25; Dow Jones -- 22; Times Mirror -- 11. What does this mean? It means that more and more newspapers look alike and think alike. This is why I read 10 newspapers a day. You have to read a lot of them to get the real story.

* *

In my opinion and born out of long experience, the two most difficult procedures on this earth are: **(1)** To get anyone to do what they say they're going to do. And **(2)** to get the correct information on any subject. I've learned that INFORMATION IS WHERE YOU FIND IT. As readers know by now, I'm not an ardent admirer of the medical hierarchy. Yes, medicine has advanced fantastically since I was a boy. Yes, medicine has come up with many marvelous techniques and cures. But doctors, as a group, tend to be stubborn and narrow minded. And new medical discoveries don't tend to be accepted until the AMA, the FDA or some pharmaceutical company says "OK."

At any rate, the current issue of *Penthouse* (yes, *Penthouse*) contains a fascinating, detailed and convincing article on **hydrazine sulphate,** a chemical that the article states has cured many cases of cancer. If this is true, it goes directly against chemotherapists who obviously make their living in another direction. I might have ignored this article except for my experience with chelation and the fierce opposition by the medical fraternity to chelation therapy. My main point is that if you have cancer or your family has a history of cancer, I strongly suggest that you at least read this article. I found it fascinating (the wife of Bob Guccione, *Penthouse* publisher, contracted a vicious type of breast cancer, used the hydrazine sulphate treatment, was evidently cured, and appears to be healthy today).

* *

Bye-Bye **Affirmative Action:** 196 blacks applied to the University of California San Diego School of Medicine here in La Jolla. For admission, the Medical School considers grades, test scores, interviews, references, socio-economic background, extra-curricular activities and volunteer work. Of the 196 black applicants, how many were accepted? Answer: none, zero.

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Thanks to *13D Research* [(208)726-1565] for the following: "Creative destruction hits the music business -- will movies be next?" The Internet promises to completely change the way products are distributed (should we say good bye to the middle-man?). Last week the Artist formerly known as Prince announced that all his future releases will be sold via the Internet. Others are sure to follow. Hollywood spends anywhere from 10% to 40% of each movie on distribution. But this could change radically if the public starts picking its movies on the Internet ("What does the review on the Net say?"). Writes expert George Gilder, "A huge variety of suppliers will gain access to audiences, and money will pass from distributors to the creators . . . A new age of individualism is coming, and it will bring an eruption of culture unprecedented in human history."

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Takeovers: Hong Kong interests via Windsor Concepts and the fabulously rich Mr. Poon are taking over Barney's. And Marvin Davis is moving into Las Vegas, as he takes control of the old Desert Inn. Poon has been itching to bring his up-scale retailing operation into the US. But Marvin, why are you moving into Vegas at this late stage of the game? Vegas is getting awfully crowded -- and c'mon, you don't need the money.

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I thought the following from the August 18 *Fortune* was interesting. It pertains to the collapse in the Japanese economy. "Even during the glory days a visit to one of those planning agencies -- say, Japan's all-powerful Ministry of Finance -- was enough to inspire a few doubts. I visited MOF in 1985 and saw what looked less like the Pentagon's War Room than like the Department of Motor Vehicles: dusty hallways, broken furniture, guys padding around in their socks, centerfolds taped to the dirty glass partitions. But maybe, I thought, appearances were deceiving. Then things started to go wrong, and the MOF proved itself as hapless in action as it was in appearance. It's easy to look competent in a prosperous economy (ask Bill Clinton), but the true test is whether you can cope with adversity. So much for the legendary managers of Japan, Inc."

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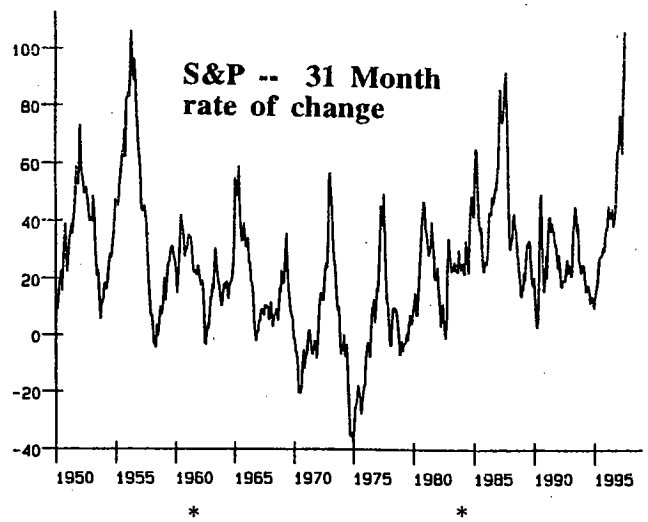
There are now more than a dozen car manufacturers in North America, but the various rates of growth are startling. Honda now builds almost as many cars in N. America as Chrysler. Here are the annual rates of growth in car output in N. America for the years

1986 to 1996. Ford's annual change -- +5.5%; Chrysler -- +3.5; Nissan -- +9.1%; Honda -- +12.5%; Toyota -- a huge +42.9%.



Speaking of rates of growth, this extraordinary chart is courtesy of *ISI* [(212)446-5617]. The current rise in the S&P began 31 months ago, so this chart shows the 31-month rate of change in the S&P. In 1956 the 31-month rate-of-change reached a record high of **106.5%.** That amazing run ended when inflation began to accelerate. The current 31-month rate of change has now risen to **106.2%.** Writes *ISI's* Ed Hyman, "The current S&P run is likely to continue until inflation accelerates." **Russell comment:** It would be a fantastic coincidence if inflation heats up just as the 31-month rate-of-change again surges over 106%.

BONDS, CASH, INVESTING: I want to comment again about last week's huge break in bonds. The chart (page 1) shows support for the Sept. T-Bond contract coming in about 111-112. It's my opinion that the bonds have topped and have moved into a broad trading range; furthermore, I'm guessing that 111-112 should (hopefully) hold the Sept. T-bonds on the downside.

The long bond (30 years) now yields better than 6.60%. At this yield, and in view of the stock market's thin valuation and dividend returns, I believe that an extended investment in the long bond at this time is more attractive and very possibly more profitable than an investment in stocks.

It is well to remember that since 1897 the Dow has appreciated (minus dividends) at only a **5.3%** annual rate -- it's the dividends that have pushed total Dow historical annual appreciation to a 10% rate. But with Dow dividends now at a minuscule 1.6%, the odds of a continued 10% appreciation become markedly less.

Trouble: Many of the Asian nations are in trouble. Unemployment is rising. They've devalued their currencies in an effort to compete (with China). **And they need cash.** Most of their reserves (and most of the world's reserves) are in US T-bills and bonds. With bonds and the dollar at highs only a week ago, where do these countries get cash? Answer: they sell some of their reserves of US bills and bonds. The total amount of US securities held overseas is HUGE (the figure I hear is about $800 billion). If the world needs cash, their assets are in US bonds and bills, and they can sell those assets for dollars, which is the world's reserve currency.

Of course, there's also real money, the money that never goes bankrupt and the money that nobody questions. It's called gold. So saying, let's take a peek at what's happening to real money.

GOLD: Despite Australia's selling of two-thirds of its gold reserves and despite the semi-hysteria about central bank selling of gold, the gold situation appears a lot brighter now than it did a few months ago.

Something "very different" is happening in the gold picture. You remember a few Letters back I drew attention to the bullish "island reversal" in XAU, the Phila. Gold/Silver Average. Since then XAU has pushed substantially and significantly higher.

The extreme low for XAU was recorded on July 7 at 85.79. That low was struck amid black gloom-and-doom predictions of 300 or 250 for gold -- one prominent advisory talked about gold breaking below 200.

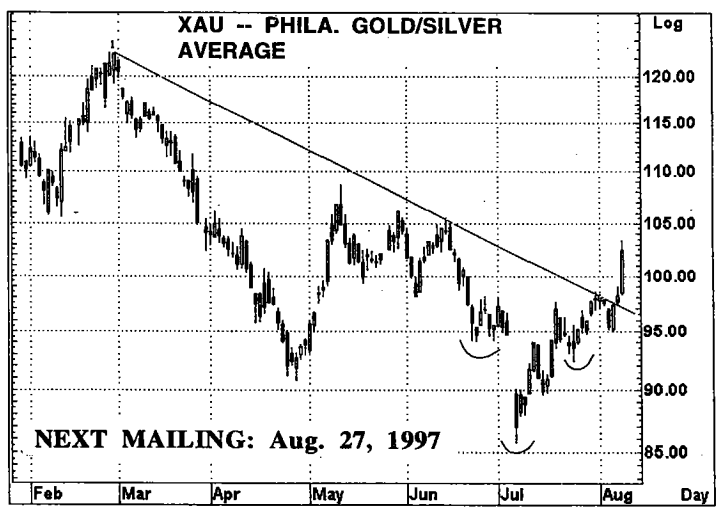
Since its 85.79 low, XAU has rallied above the "breakout level" of 100 (this occurred on August 8). At the August 8 close XAU had advanced better than 16% since its mid-July low. "To walk a mile, you have to take a first step," and for a new trend to start you have to break the downside momentum and start moving up. That's exactly what XAU has been doing, and it could be what gold, the metal, is about to do.

So far, the gold shares (read XAU) have been acting considerably **better** than physical gold. Now turn to the chart below of XAU. Here is what has happened: XAU **(1)** formed a three-day "island reversal" bottoming pattern at the extreme lows; **(2)** a "head-and-shoulders" bottoming pattern appeared; **(3)** XAU broke out above upside resistance at 100; and **(4)** XAU broke out above the five-month bearish declining trendline. Reversing the declining trendline puts XAU in line to attack the May peak of 108.74.

Conclusion: The ratio of gold to the Dow suggests that gold is ridiculously **cheap** (the Dow at 8050 will buy 24 ounces of gold). Physical demand for gold is now at the highest level in history with heavy buying coming from Asia. There is a huge short position in gold, equal to one year's production (with many mines having sold tons of forward gold). But that's just the background. The critical question is whether XAU and the metal will continue to move higher. The next major objective for XAU is above 110. The next major objective for gold, the metal (basis the December futures), is 335.

Remember this -- the central banks can sell gold for US paper, and the Fed can try to manipulate gold to mask inflation -- but the central banks can't manipulate all the gold shares -- which is one reason why the shares are leading the metal to the upside.

Top gold choices -- Newmont Mining and Barrick Gold. Also Toronto's Euro Nevada and Franco Nevada.



LATE NOTES: The big question on Wall Street's mind and on the mind of every fund manager is how low the bonds will go. The stock market has been trading off interest rates ever since 1993 (when the yield on the Dow broke below 3%). As the bonds decline and as interest rates rise, the pressure builds on the stock market.